February 12, 2024

Mr. David Miller
Chair of the Investment Committee
California Public Employees' Retirement System
400 P Street
Sacramento, CA 95814

Re: Item 6a: Mid-Cycle Public Employees' Retirement Fund Asset Liability Management Review

Dear Mr. Miller,

You requested Wilshire's opinion on Staff's recommended PERF allocation targets in accordance with CalPERS scheduled mid-cycle Asset Liability Management (ALM) review. The establishment of the portfolio's strategic asset allocation targets is a key Investment Committee (IC) decision, and the mid-cycle review provides an opportunity to review and adjust the PERF's current targets that resulted from the comprehensive ALM process, last approved in November 2021. Allocation changes made during the mid-cycle process are intended to drive portfolio allocations until the next full-cycle review in 2025-2026.

CalPERS Investment Belief 6 recognizes that strategic asset allocation is the dominant determinant of portfolio risk and return. Consistent with its importance to the organization, the asset allocation decision also touches upon a meaningful number of CalPERS' other core Investment Beliefs. Most notably, Investment Belief 1: Liabilities must influence the asset structure and Belief 2: a long-term investment horizon is a responsibility and an advantage.

The ALM Mid-Cycle Review Process

Wilshire believes that Staff followed a prudent mid-cycle review process, which provided transparency and the opportunity to solicit IC feedback (including related discussions during the November 2023 IC meeting and January 2024 Board offsite). Wilshire also had the opportunity to meet with Staff throughout the process, providing us frequent occasions to monitor progress, probe into areas of perceived ambiguity, and to provide our independent and candid feedback.

As was discussed during the November 2023 IC meeting, Staff focused their efforts on identifying portfolios consistent with the Committee's previously approved level of risk, as expressed via the current target allocation's ~21.5% Conditional Drawdown at Risk (CDaR) estimate. Wilshire views this as a sensible approach to identifying an appropriate level of expected portfolio risk (and one that is consistent with the IC's last-specified risk appetite).

Staff utilized updated capital market assumptions (CMAs) from its well-communicated survey process. As both a participant in CalPERS' survey process and in having the opportunity to compare the survey results to Wilshire's own in-house CMAs, we are comfortable that the result of using the survey's consensus views to drive these important inputs are reasonable and appropriate estimates of the capital market environment.

Recommended Portfolio

Below we highlight several notable characteristics of the recommended portfolio (Candidate A from the November 2023 IC presentation) and provide observations on how the proposal compares to the PERF's current target allocation.

- <u>Small shift from Total Growth (i.e., Public + Private Equity) to Total Debt (i.e., Fixed Income + Private Debt)</u>: While there are notable changes withing these broader groups, the proposed portfolio represents a 1% shift from Public & Private Equity into Fixed Income & Private Debt. The relative shift is generally consistent with the improved CMA prospects of fixed income and debt asset classes versus equity segments.
- <u>Increase in Private Equity (PE)</u>: Despite the 1% shift out of Total Equity noted above, the proposed portfolio reflects a material 4% increase in the target allocation to Private Equity (from 13% to 17%). This increase is effectively funded by a 5% proposed reduction in Public Equity (from 42% to 37%). As is indicated in Staff's presentation materials and was discussed at some length during the November IC meeting, the proposed increase in PE is primarily driven by an increased belief in CalPERS' ability to successfully deploy PE commitments rather than an improvement in the underlying return expectations between private vs. public market equities. The PERF's current overweight relative to its 13% Private Equity target portfolio weight, while driven in part by market forces, provides some evidence of Staff's ability to deploy private market commitments more rapidly than what had been assumed in previous ALM deliberations. While Wilshire finds Staff's revised perspective on its ability to successfully deploy a greater level of assets into the private markets to be feasible (both from direct discussions with Staff and from related IC agenda discussions), we encourage the Committee to probe the PE team for their level of comfort with the requisite underlying accelerated implementation plan. It is worth noting that, even with additional expected commitments and under the best of conditions, it will likely take substantial time to reach the proposed PE target allocation. The IC will, therefore, have the opportunity within the upcoming 2024-2025 full ALM cycle to assess progress towards this increased target and make any desired target modifications during that process.
- <u>Increase in Private Debt</u>: The proposal calls for an 8% target allocation to Private Debt, which represents a 3% increase from the PERF's current 5% target. Private Debt is a relatively new allocation sleeve within the portfolio and Staff's positive experience in building the allocation up towards its initial 5% target provides comfort that a further increase to 8% is reasonable. Along with the PE increase noted above and the portfolio's 15% target allocation to the Real Assets segment, the overall proposed allocation to private asset segments is 40%. While this increase is entirely consistent with the organization's strategic objectives, the cumulative allocation across all private market investments should be monitored against CalPERS Liquidity Dashboard to ensure that the PERF maintains its robust liquidity profile despite the larger commitment to these less-liquid investments.

Conclusion

Wilshire believes CalPERS followed a prudent process in conducting the mid-cycle ALM review, informed by reasonable inputs, and focused on the identification of portfolios at appropriately specified risk levels. The proposed portfolio has attractive relative return/risk characteristics compared to the current policy portfolio. For example, the allocation is expected to deliver a slightly higher return (7.0% vs. 6.9%) at a comparable level of CDaR (21.4% vs. 21.5%). The proposed portfolio also has a similar level of expected volatility when compared to the PERF's current target allocation (11.3% vs. 11.2%).

Notwithstanding the risks noted above, Wilshire is comfortable with the recommended portfolio. By systematically stepping through this process in a disciplined way, allowing guidance from each step to drive the direction of future steps and by including feedback from key stakeholders, the Investment Committee can be comfortable that the resultant, proposed portfolio is consistent with its portfolio preferences, return objectives and appetite for various forms of risk.

Please do not hesitate to contact us if you have any questions or require anything further. We look forward to discussing this item with you during the March IC meeting.

Best Regards,

Steven J. Foresti - Senior Advisor, Investments
Wilshire Advisors LLC

